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Economic Conditions
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General Business Conditions

THE inflationary dangers in the economic situation have come to the front again during the past month. In many parts of the country a rush to buy has lifted sales of department stores, clothing and apparel stores, and food stores to the greatest volume ever experienced except at Christmas time. This buying is primarily a public reaction to anticipation of shortages and additional rationing. It is also, however, a demonstration of the unprecedented purchasing power which the war disbursements are spreading over the country, and which constitutes the inflationary menace. As a rule merchants do not complain of big sales, but they are under no illusion that such unseasonable and exaggerated business represents a healthy condition. It results in hoarding, maldistribution and probably waste of goods that manufacturers and distributors are in many cases hard put to replace, and makes it more difficult to meet demands and to conduct an orderly business later on.

The incomes which are permitting consumers thus to satisfy both present and future wants will continue to increase as war expenditures expand. Unless the increase is absorbed back into the Treasury, either through greater taxation or greater sales of Treasury securities in the brackets where the increased income exists, it will add further to the potential demand for goods.

"Normal Consumption" No Longer the Guide

Previous ideas of what is the "normal" consumption or needs of consumers' goods become almost meaningless under present conditions. There may be enough meat and dairy products for dietary needs, or enough shoes and clothing for past standards of consumption. Under present conditions, however, supply is not to be measured against either basic needs or past standards of use, but against the urge of people who have more money than before to buy more and better goods than before, and against their tendency to panicky buying when they are alarmed or confused as to the outlook. This is where earlier calculations that supplies of one thing or another would be "adequate" have gone astray.

The country now recognizes, — all the more plainly after the developments in the food and clothing markets during the past month, — that this inflation of demand requires more widespread and stringent controls of consumption as an adjunct to price controls, if price controls are to be effective. The meat situation, for example, would be better, and violations of the regulations less prevalent, if rationing had begun some months ago, before the disorder in meat distribution developed and before black markets became established. On the other hand, it is equally true that as consumption controls grow more severe the inequities and strains created are greater, and it becomes increasingly difficult, and in some respects impossible, to devise plans that will work and to enforce them after they are devised. No one can now say what effects the state of confusion and uncertainty in the food trades may have upon food production and distribution, except that it plainly cannot be helpful.

The main lesson to be drawn from the difficulties with the controls is one that has been emphasized by every student of the inflation danger from President Roosevelt down. It is that demand must be reduced to the limitations of supply not only by direct controls, but by measures to keep out of the markets the surplus purchasing power which the war expenditures put into peoples' hands. This means more saving by people, and higher taxes and greater sales of bonds to individuals by the Treasury. The growing inequalities in the distribution of essential commodities and the spread of violations of the O.P.A.'s regulations are in a sense evidence that the attack on the inflation menace through fiscal policy needs to go further. Controls through the fiscal program and direct price and consumption controls support each other. The more the former are employed, the less severe and the more effective the latter may be. A principle that is now being widely learned is that production and distribution gen-

erally function better under flexible prices than under rigid prices; and a relatively greater reliance upon fiscal measures to absorb income into the Treasury makes it possible to maintain a greater flexibility in price control without jeopardizing the anti-inflation program.

Labor and the Little Steel Formula

The second area in which the inflation danger has come to the front is in the presentation of demands for new wage increases. The United Mine Workers are asking a $2 a day advance when their present wage contract expires March 31. The executive board of the Congress of Industrial Organizations has adopted a declaration that wage adjustments must make allowance for the increase in the cost of living since May 1942, when the Little Steel formula took effect. President Green of the American Federation of Labor says the Little Steel formula is too rigid, and that labor is dissatisfied because the rise in the cost of living is getting out of bounds.

Mr. Byrnes, the Economic Stabilization Director, has replied to the demands of the union leaders with a strong statement. He said: "We must not retreat in our fight to stabilize the cost of living . . . We must hold that line . . . There must be no further increases in wages beyond the Little Steel formula," except in limited and special cases as provided in that formula. The National War Labor Board took that ground in refusing a general wage increase to the employes of the meat packing companies.

To terminate the inflation spiral, the Government has adopted and public sentiment wholeheartedly supports the policy of stabilizing prices and wages. The first essential in a wage stabilization program is to establish and adhere to a formula to govern wage decisions. Any practicable formula is better than no formula at all. The Little Steel formula was adopted for this purpose. Its value in promoting stabilization is not that it is perfect, but that it is workable, provided there is readiness to accept it, and a will among all concerned to make it work.

The formula is more than fair to wage earners. It selected January 1, 1941 as the measure of "established peacetime standards," although hourly wage rates were then 9 per cent higher and weekly wages 12 per cent higher than at the start of the war and the cost of living had hardly changed. It in effect guaranteed to all industrial workers an increase of 15 per cent in hourly wage rates over the rates of January, 1941; and actually the buying power of weekly earnings, taking into account longer hours and overtime pay and allowing for the higher cost of living, between August, 1939 and May, 1942 increased 32 per cent. Furthermore, it provided for additional wage increases by requiring "due consideration of inequalities and the elimination of sub-standards of living."

If the formula should be destroyed, little hope of a reasonable degree of price and wage stabilization around present levels would remain. The key principle is that one man's earnings are another's costs. The effect of another general wage increase would be to raise costs further, put new pressure under prices, lead to demands from other groups of people, and so set off another revolution of the inflation spiral.

Changes Since May, 1942

Since May 1942 the cost of living, according to the official index of the Bureau of Labor Statistics, has risen 4 per cent, which is doubtless an understatement in view of hidden costs not covered in the index. In the same period, however, average hourly wages have advanced 9 per cent, and average weekly wages 7.5 per cent. Even in the case of those workers who have had no increase since May 1942, the argument that they should have compensation for the cost of living rise assumes that they are entitled to maintain their standards of living. But the standard of living is not in money income but in the availability of goods and services which people can use. The war will reduce all living standards. The production of industrial goods for civilian use in 1942 was more than a third less than in 1941, according to the Department of Commerce. It will be possibly 15 per cent lower in 1943 than in 1942. Food supplies will be smaller, and fewer services will be available.

If factory workers are to be assured of money incomes which will permit them to claim the same aggregate of goods and services as in 1941 all others will have to do with far less. This is not only inequitable; it is impracticable. The cut in living standards can be borne if it is spread widely, but not if the burden falls wholly on unprotected groups.

It will be argued that the industries can pay higher wages, but the showing of a decrease in industrial earnings in 1942, given in the compilations appearing on later pages of this Letter, supports a contrary view. As to the 1943 outlook, an extract from the third quarterly report of the Office of Price Administration, issued January 19, 1943, is pertinent:

> In general it must be recognized that the "honeymoon" period of industrial expansion is over. In many industries production is now past the level which may be termed optimum from the viewpoint of efficiency. Costs are increasing month by month. Furthermore, the steady withdrawal of skilled men for the services, the increasing difficulty in replacing obsolete equipment and in making repairs, the necessity of using substitute and more costly raw materials, the congestion in transportation — indeed all the strains and pressures which are the inevitable consequence of total mobilization — spell increasing costs of production and increasing pressure upon our price ceilings.

Another pertinent extract from this report is the following:

> Flexibility in price management is possible only when control is firm. When control is infirm, flexibility must quickly degenerate into a rout.

The 48-Hour Week

The executive order establishing the minimum 48-hour work week raises complex questions, chiefly because of its effect upon industrial costs. Applied first to 32 areas in which the labor shortage is critical, it is primarily a move to carry on civilian work with a smaller labor force and thereby make more workers available for war production. It puts into practice the principle that people should work longer hours in these critical times, which is clearly a move in the right direction. The labor supply is one of the limits upon production, and before resorting to more difficult and debatable measures to break the bottleneck it is obviously desirable to lengthen the work week. In Great Britain a plant in which the standard minimum working week is below 52 hours for industrial labor is not deemed to be using its force to full capacity, and the average work week is 55 to 60 hours.

The order will have little practical effect upon armament producers, most of whom are already on a 48-hour week or longer. Some plants and trade and service establishments coming under the order will find it difficult to plan an efficient 48-hour operation, but where the difficulties are insurmountable the regulations of the War Manpower Commission provide for exceptions. It is intended that the order shall be sufficiently flexible to effect the change smoothly.

The Increase in Costs

Under the Wages and Hours Act, time and a half must be paid for all hours worked above 40 per week. Mr. Byrnes in his announcement of the measure stated that "while overtime payments will add to the wage bill, the addition will be largely made up by the increased production secured." This statement seems to minimize the increase in labor costs. Actually workers will be paid 30 per cent more for doing 20 per cent more work, and the extra pay spread over the full week's product will, mathematically, raise unit labor cost by 8⅓ per cent. The increase in overall production costs will vary with circumstances, but necessarily they will rise. As consumers' goods are under price ceilings, new upward pressures against these ceilings will be created. Also, labor will have an increase in money to spend, out of proportion to any possible increase in what it can buy. These are the inflationary effects.

Published statements by Mr. Byrnes, Price Administrator Brown and others indicate that the industries will be expected to absorb increased costs without upward revision of price ceilings. To what extent they can do this remains to be seen. We have already quoted the opinion of the O.P.A. as to the trend of industrial costs, even before considering the new move. If the civilian industries could pay for overtime operations, as these officials believe, it is surprising that more have not worked overtime, for the law has not prevented and they have had enough demand for their goods. The fact is that few have found overtime work profitable. When the coal mines recently began to work an extra day per week, at time and a half, it was necessary to permit advances in both bituminous and anthracite prices to cover the increased cost.

Thus interpretations to the effect that the order is inflationary in its nature are correct. This, however, is but one aspect of a complex question. Other practical considerations must be taken into account. The basic idea that time and a half pay is necessary to procure overtime work in war seems repugnant to the patriotic instinct. It is adding billions to the cost of the war, to the debt, and to the inflationary danger. It is a holdover from the days of the policy of "making work" and is inappropriate to the present time. On the other hand, the practice is deeply imbedded in present methods of compensating labor, it could be withdrawn only by act of Congress, and its arbitrary abolition doubtless would cause general demands for revision of basic wage scales and throw industrial relations into turmoil. That is one thing which the country cannot afford at this time. It is equally impracticable to create an inequality, such as would be done if continuance of time and a half were permitted in plants already paying it, but denied to the workers now going to 48 hours.

With respect to the level of production costs that will prevail after the war, when excessive costs would menace economic stability, it is better for workers to have overtime pay during the war than that basic wage scales should be raised to provide the same weekly earnings. For the increase in costs under the overtime arrangement is temporary, and is automatically cancelled when overtime is discontinued.

But however compelling the practical reasons for the order, and its advantages otherwise, it is at the same time a retreat before the inflationary dangers. The pressing consideration now is to minimize the effects of the retreat by strengthening the defense in other quarters. The two main dangers are the surplus buying power already accumulated and still increasing, which must be absorbed into the Treasury, and the pressure of special groups for advantage, in the vain effort to reduce their share of sacrifices which all must bear. Over all is the obligation of the individual to work and save.

The Second Victory Loan

Secretary Morgenthau's announcement of a second Victory loan drive in April to raise at least as much as and probably more than the $13 billions in the December drive was in line with expectations and formally establishes the

next major objective in the borrowing program. From now on the prospect of this huge operation takes first place as a money market influence and in the thinking and planning of bankers and the investment community.

Although the December drive was a gratifying success for a first attempt of such magnitude, it is going to take a lot more to be accounted a success in April. Success then will be judged not so much by the total funds raised—there is no question about getting the money—as by how they are raised.

First and most important, there has got to be more money raised outside the banks. This is necessary, both to keep down the inflationary expansion of bank credit, which is the worst evil of war finance, and to encourage individuals, especially war-workers, to invest as much as possible of their current incomes in war bonds instead of competing for the limited supplies of goods.

Second only to the need for selling more securities outside the banks is the need for spreading the geographical distribution of these issues more broadly.

In the December drive and in the case of earlier Treasury offerings, too much of the financing has been carried in the principal money centers—where large corporate and insurance balances are kept. Since Treasury borrowing and tax collections in the financial centers are spent chiefly in the war industry areas, disproportionate subcriptions in the money centers tend toward unbalanced distribution of funds. It means a constant drain on these centers and accumulation of unused funds in the interior, thus detracting from the most effective utilization of available resources in the war effort and complicating the task of the Reserve Banks of keeping the money markets adequately supplied.

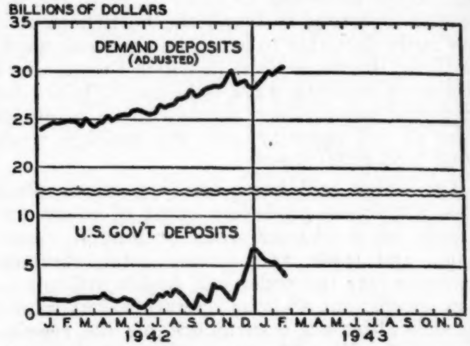
This situation should be remedied, of course, not by any let-up in the sales effort in the money centers, but by redoubled efforts in other districts.

Bank Subscriptions and Bank Deposits

One reason, undoubtedly, that has deterred many banks throughout the country from putting idle funds fully to work in the purchase of new Treasury issues has been the fact that bank excess reserves are now much smaller than those upon which banks have been accustomed to operate in the past. Only recently have the banks worked under the new Federal Reserve pattern of limited excess reserves, but ready facilities for the sale of and repurchase of Treasury bills to and from the Reserve Banks as a means of adjusting their reserve position.

Neither is there a clear understanding of precisely what happens when banks subscribe to new Treasury issues. This is largely done by crediting Treasury "war loan deposits" on their books. When the Treasury needs these funds for disbursements, their subsequent transfer to the Federal Reserve Banks for government account involves only a temporary loss to the banking system. As the funds are paid out almost immediately they return to the banks in the form of ordinary individual and commercial deposits.

This process is illustrated by the accompanying diagram, which gives the trend of ordinary demand and government deposits of the weekly reporting member banks over the past year.



Ordinary Demand Deposits (Excluding Interbank) and U. S. Government Deposits of the Weekly Reporting Member Banks.

It will be seen that the various ups and downs of government deposits in the banks last year were accompanied by a steady rise in ordinary demand deposits. While the heavy December financing resulted in the building up of government deposits, and a considerable draft on demand deposits, the subsequent Treasury expenditures resulted in a drawing down of government deposits and a rebuilding of other deposits, which on February 17 reached levels higher even than before.

It is true that in this flow of funds into and out of the Reserve Banks for account of the Treasury, the deposits do not always come back to the same banks. As already noted, there is a strong tendency for deposits to flow toward those areas active in war production. It is interesting to find, however, that while some districts have gained deposits much more rapidly than others in the year and a half since the national defense program got under way, there have been substantial gains in all Federal Reserve Districts, and in the central reserve and the reserve cities as well as country banks, as shown by the table on the next page.

This growth of deposits and consequent increase of reserve requirements, together with a large expansion of currency, without borrowing of banks from the Federal Reserve Banks, has been made possible by the policy of the Reserve Banks in making additional reserves available

Percentage Change in Total Deposits of All Member Banks June 1940 to December 1942

	Central Reserve Cities	Reserve Cities	Country Banks	Total
Boston		+34	+37	+36
New York	+31	+32	+39	+32
Philadelphia		+22	+26	+24
Cleveland		+39	+50	+43
Richmond		+53	+75	+63
Atlanta		+57	+80	+68
Chicago	+38	+74	+63	+54
St. Louis		+59	+71	+64
Minneapolis		+66	+52	+59
Kansas City		+68	+77	+71
Dallas		+69	+84	+75
San Francisco		+57	+81	+60
Total	+32	+52	+55	+45

as needed through open market purchases of government securities and lowering of the legal percentages of reserves required against bank deposits.

Proposed Legislation Affecting War Loan Deposits

The pending bill in Congress sponsored by Senator Wagner and Congressman Steagall exempting war loan deposits in banks from the usual legal reserve requirements, and from Federal Deposit Insurance assessments, is intended to give further aid to banks in carrying the heavy load of their share of Treasury financing. The bill, which would apply until six months after the end of the war, has the approval of the Treasury and the various federal bank supervisory agencies.

The proposal to remove war loan deposits from the category of deposits requiring reserve would mark a return to the practice that prevailed during the last war and up to enactment of the Banking Act of 1935. There are good grounds for the move in the fact that government deposits are, and will continue to be, secured 100 per cent by government bond collateral. The practical effect of the change would be to postpone the need for added reserves until the war loan deposits created by government borrowing are converted into ordinary deposits through Treasury expenditures. Since this takes place gradually, it would mean spreading the need for increased reserves over a longer period, thus giving the banks greater opportunity to make adjustments and minimizing possible pressures on the market. Moreover, since there is always a certain amount of war loan deposits in the banks, the new law would to this extent bring about a permanent reduction in reserve requirements and an increase in excess reserves.

The proposal to exempt war loan deposits from the Federal Deposit Insurance assessment of 1/12 of 1 per cent annually is warranted both by the growth in income and total assets of the Federal Deposit Insurance Corporation and by the fact that war loan deposits represent investment not in risk assets but in U. S. Government securities. It will help promote a wider participation in federal financing by banks throughout the country. As the deposits pass out of war loan accounts and merge with other deposits, they will of course become subject to assessment.

When the permanent deposit insurance plan was adopted in 1935, deposits of insured banks totalled approximately $45 billions, and assessments in the first full year of the plan amounted to $35 millions. By the end of 1941 the deposits had grown to $71 billions and assessments to $51 millions. In the same period the income from investments increased to over $10 millions, while total assets of the Fund now exceed $650 millions, more than 80 per cent invested in government securities.

With the way these funds have been piling up, the time ought to come before very long when the rate of assessment can be reduced. In the uncertainties of the war period, there is a natural reluctance to give consideration to this problem, but it will have to come eventually because of the burden upon the banks which should be accumulating earnings and building a strong capital position in order to play their part in financing post-war industry and employment.

While an insurance fund of over half a billion, or even a billion dollars, may not appear large when measured against the aggregate of deposits, it is obviously impossible to build a total large enough to pay off all depositors in the country. All that can be hoped for is to provide protection in limited emergencies, and by prompt action forestall the spread of panic involving other institutions. Beyond that, safety in banking and security for bank depositors depend upon supervision and good management that will hold down banking losses, and upon an adequate cushion of bank capital to absorb losses.

Settlement of War Contracts

In the growing amount of discussion of the post-war economic situation, too little public attention has been given thus far to the question of settlement of war production contracts when the war ends. Many people may think this a matter of little general interest, concerning only the Government and the armament producers. Actually, it concerns the whole country. For there is involved the question whether the industries will be able to take up peacetime work quickly after their war work is over, or whether their working capital will be frozen in war production and its release subject to interminable delays and litigation.

This concerns a great many people. It concerns the possibly twenty million persons who will be working in the war industries, most of

whom will need peacetime jobs after war production is suspended. It concerns the millions in the armed forces who will be back looking for work after peace is restored. It concerns all who sell to the industries now producing war products, and all who will be looking for a market among their workers.

The producers of automobiles, radios, farm machinery and consumers' durable goods generally, who have converted wholly or in large part to production of a different kind than they normally carry on, will be particularly affected. To turn out their accustomed products once more they will have to reconvert, install new tools and machinery, rearrange plants, and buy the new materials required by the changeover. Unless they can begin reconversion as soon as their war contracts are terminated, and proceed rapidly to normal operations, this great section of the country's industry will stagnate, and the effects on employment will be multiplied by the depression of industries which supply these plants with parts, materials and supplies.

The danger that such a jam may develop arises from the completeness with which such concerns have turned to war production. Necessarily their liquidity has declined. Their working capital has been strained to carry their greatly increased inventories of materials and goods in process, and their expanded accounts receivable. Although the Government has financed much plant expansion, most contractors have put some of their own resources into new facilities. The result is that in very many cases most, if not all, of their pre-war working capital plus their retained earnings is represented on their balance sheets by increased inventories, receivables, or plant accounts, instead of cash; and as a rule borrowing from banks or the Government has been necessary to help provide for tax payments and maintain working balances.

Evidence that the foregoing correctly describes the situation is given by the tabulation of a composite balance sheet of 100 manufacturing corporations which appears in the report of corporate earnings in this Letter (page 35). This table shows that while working capital has increased during the past two years, all the increase and more is locked up in higher inventories and receivables, and cash would be even lower except for an increase in notes payable (chiefly bank borrowings). The companies whose figures are included in this tabulation represent a general cross section of industry; because few complete reports for 1942 have been published to date it has not been practicable to make a separate compilation for companies converted to war production, but in such companies the decline in liquidity as a rule has been greater than average.

Effects of Contract Cancellation

The situation described does not limit war production, but its influence upon the post-war situation should be apparent. At or about the end of the war the companies whose working capital is thus invested in war production will have most of their war contracts cancelled or slowed down. The flow of materials through the manufacturing process, to be turned into finished goods and thence into cash, will be interrupted. Contractors will be left with raw and partly fabricated materials on hand or committed for, large accounts payable and accrued payrolls, and probably commitments of other kinds. At the same time their needs for cash will increase. They will have to make outlays for reconversion and new materials. They will need money to pay the income taxes that will be due for the last war year. In many cases they will have debts coming due also; and even if debts can be extended taxes will constitute a first lien on their cash, coming ahead of the reconversion outlays upon which their ability to give employment will depend. Some may have payments to make to the Government in consequence of renegotiation of contracts.

In order to free their working capital for new production, the war producers must realize upon their claims against the Government. The war contracts normally provide in effect (although as yet no uniformity in the cancellation provisions has been established) that in event of termination for the convenience of the Government the contractor will be compensated for his costs and commitments on the uncompleted portion of the contract, plus some allowance for reasonable profit on work done. Prime contractors in turn have the same obligation to sub-contractors, and they in turn to those from whom they buy.

In principle this arrangement is simple. In practice it may be immensely complicated. At best, contractors will be hampered by uncertainty not only as to *how much* they can expect to receive after cancellation, but even more as to *when* the correct amount will be established and how soon thereafter they may be paid. But upon these payments will depend their ability to make new commitments and expenditures. At worst, they will be faced with frozen working capital, frozen debts and frozen credit — including not contractors alone but those they normally buy from and sell to.

Conversely, if prompt settlement is made, indebtedness can be paid, credit restored, and management and labor put immediately at work preparing for production of civilian goods.

That this is a question of vital national interest and urgency is shown further by consideration of the amounts that may be involved. At the Armistice in 1918 the War Department

alone had outstanding more than 24,000 contracts calling for production valued at more than $7.5 billions.* All these contracts were at once "suspended." Later some further limited production was allowed in most cases, and certain contracts were reinstated completely; but the bulk, in money value, of the contracts were cancelled. Ordnance contracts alone represented a value of $4 billions, and their cancellation gave rise to 4,500 claims totalling $2.5 billions.

In this war the production program is more than ten times that of the last war. If ten be taken as a conservative multiplier it appears that the number of contracts outstanding at the close of this war may exceed $75 billions. In any case, the sums due on contract settlement will be immeasurably greater than in 1918. Greater, also, will be their relation to industry's financial resources and their importance as a governing factor in the ability of the industries to get ahead with peacetime work. The industries chiefly affected — the producers of consumers' durable goods—play an immensely greater part in our economic life.

Reasons for Delay in Settlement

Willingness of the government departments and agencies to make settlement upon cancellation as promptly as possible may be assumed, but the reasons for delay are many. One is the physical magnitude of the job. Of course the payment due must be properly and accurately ascertained, and delay will arise because of the impossibility of auditing all contractors' accounts promptly. It may arise because contracts cancelled are under renegotiation or because the Government desires to renegotiate them. It may arise from differences of contract interpretation, or from a variety of other causes. For all these reasons settlement of the contracts may be long drawn out.

In the middle of 1919, seven months after the Armistice, 50 per cent of the ordnance claims had been settled. One year later, June 30, 1920, the percentage was 89, leaving 11 per cent (generally the cases where the largest amounts were involved) still unsettled. To take one example — not the most flagrant — E. I. du Pont de Nemours Co. had nine smokeless powder contracts, all at fixed prices and in such form that the legality of the company's claims was unquestioned. The principal scaling down of the claims came through a reduction in inventory valuation, by substituting average prices over the period of the contracts for current post-Armistice prices, at which the company had valued its materials; and this appears to have been settled more easily than certain minor points. Yet negotiation of these claims lasted for more than two years, and payment was not made until the Spring of 1921. The source of this account (see previous footnote) says, "Thus an open and shut case, in which the contractor had a clear guarantee against loss from termination of his contract, dragged out over two and one-half years." It adds, "The absence of these funds ($19 millions) from a company's operating capital would seem likely to hamper post-war readjustment," although it goes on to say that "the du Pont company survived the freezing of the funds remarkably well."

A Proposal to Speed Settlements

All the foregoing is evidence of the desirability of suitable preparation, before the end of the war, to settle war contracts quickly and to make prompt payments. The purpose of this article is to suggest that the objective of government policy and preparation should be to make substantial partial payments on contractors' claims as soon as the claim can be filed; and to suggest steps that will facilitate not only the contractor's determination of his claim, but the Government's verification.

The first essential would seem to be that the methods of accounting on government contracts should be acceptable to the government department involved, and that the Government should be familiar with the method and have approved it, in advance. To do this, it would seem desirable to prepare and publish for contractors a code of principles with regard to methods of keeping their accounts. Promulgation of such a code during the war would prevent confusion and avert friction after the war. Necessarily the code would be on general lines, for except as to the elements of cost there can be no one method of keeping books which can fit the character and provisions of all contracts or be equally acceptable to everyone concerned. Nevertheless, it would seem practicable to set forth principles which would make it feasible for the Government to approve the method of bookkeeping that a contractor is following, or to tell him what method he should follow, on a specific contract.

To this end, it is proposed that the War and Navy Departments and the Maritime Commission set up a division or section of audit and accounting to function during the war, with the definite objective of facilitating post-war settlements and co-operating with contractors for that purpose. The division or section would be charged with the promulgation of the accounting principles, and authorized to approve contractors' methods in the manner outlined. The proposal seems all the more natural and feasible now that the Government is engaged in renegotiation of contracts, which requires examining the accounts of contractors and becoming familiar with their methods.

*This and subsequent information on settlement of World War I contracts is taken from "Termination of Ordnance Contracts, 1918" (Hist. Study No. 57), by J. Donald Edwards, U. S. Bureau of Labor Statistics, January, 1943.

Some may feel that the suggested procedure would require acceptance of a standard basis of cost determination by several government departments and many thousand contractors, which is hardly feasible; but this is not proposed. In other connections the Government has given guidance on accounting principles without providing any rigid formula or set procedure, and the results have been beneficial. Nor does standardization of accounting seem necessary. What is necessary is to reduce the area of potential disagreement and litigation, with the double purpose of reducing the difficulties of settlement at the end of the war to manageable proportions, and establishing a basis for making a prompt partial payment, which from the viewpoint of the economic situation is worth any amount of effort.

Any effective move to establish approved accounting methods, and give approval in advance, would facilitate attainment of both objectives. Nothing could so expedite the verification and audit of the contractors' figures. It would resolve conflicts of interpretation in advance, remove causes of dispute which otherwise might drag the settlement out interminably, immensely speed up the accounting work connected with settlement, and altogether reduce the task to such an extent that it could be managed within a reasonable time. Contractors obviously would have an interest in giving full co-operation.

Immediate Partial Payments Needed

Under such provision, immediate payment of at least part of the amounts due should be feasible. Thus the government departments and agencies should find it possible, and should undertake, to advise every prime contractor that if his books are kept in an approved manner, as checked by the division of audit and accounting, the Government will pay to him, upon cancellation of a contract, say 75 per cent of the amount due to him as shown on his books, within ten days after receipt of his sworn certification. Additional amounts due could be paid each month while final settlements were being determined. The contractor's figures could be verified by the division of audit and accounting; or if it should be impracticable for the personnel of the division to cover the field with sufficient promptness, then verification by an approved firm of registered accountants — meaning in practice the firm usually employed by the contractor — should suffice, even if it should be necessary to swear them into government service at the time.

Nothing more is included in these suggestions than doing in advance, as far as practicable, a task that must eventually be done anyway. The public interest, however, is greatly involved. Any delay in making settlements with and remitting payments to the war producers means delay on their part in changing over to peacetime production, and any delay in changeover means men out of work. The dangers of unemployment and disorganization after the war are acute. Where these dangers can be averted by forethought and preparation, every possible step should be taken as early as possible, without waiting until the dangers are at hand. All the elaborate plans to lift postwar production, employment and income to new levels will be of little avail if the corporations, by whom the bulk of the country's business is done, are left with their working capital tied up in war products, long after the end of the war.

Earnings of Manufacturing Companies in 1941-42

Annual reports for 1942 issued by leading companies reflect the tremendous expansion made in the volume of production by American industry last year in meeting the unprecedented demands for war products and materials. New high records in value of output were established by a large portion of the companies reporting, although many companies in the non-war industries had only moderate gains and a considerable number experienced actual decreases, due to priorities on raw materials and inability to convert to war goods. New peaks were reached last year in employment and payrolls in the manufacturing industries as a whole, with increases over 1941 of 13 per cent and 42 per cent, respectively.

In contrast with these increases in industrial volume, corporate earnings were generally lower. A tabulation of the reports of 710 leading manufacturing companies, having aggregate capital and surplus of approximately $12,585 millions at the beginning of last year, shows combined net income (less deficits) in 1942 of $1,210 millions after taxes, which compares with $1,397 millions for the same companies in 1941 and represents a decrease of 13 per cent.

The figures, subject in many cases to renegotiation of the terms of government contracts, indicate that the fourth quarter had better earnings than the preceding three quarters. One factor in the better fourth quarter showing was the adjustment of previous over-reserves for taxes; larger volume and completion of conversion were also important.

The great expansion in business last year brought in most cases an increase in net income before taxes, despite the rise in labor and material costs and in reserves. There were exceptions, however, among representative companies in the steel, automobile, chemical and other lines, whose net income before taxes was lower.

Estimated liability for federal income and excess profits taxes of the group increased from

NET INCOME OF LEADING MANUFACTURING CORPORATIONS FOR THE YEARS 1941 AND 1942

Net Income is Shown after Depreciation, Interest, Taxes, and Other Charges and Reserves, but before Dividends. — Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.
(In Thousands of Dollars)

		Net Income Years		Per Cent	Net Worth January 1		Per Cent Return	
No.	Industrial Groups	1941	1942	Change†	1941	1942	1941	1942
15	Baking	$ 20,127	$ 22,375	+ 11.2	$260,287	$243,813	7.7	9.2
13	Meat packing	50,304	49,085	— 2.4	565,627	592,271	8.9	8.3
56	Misc. food products	40,062	53,319	+ 33.1	474,171	487,339	8.4	10.9
84	Total food products	110,494	124,779	+ 12.9	1,300,085	1,323,423	8.5	9.4
16	Soft drinks	44,591	33,804	— 24.2	116,989	128,758	38.1	26.3
16	Brewing	5,845	5,720	— 2.1	41.072	43,017	14.2	13.3
7	Distilling	23,556	26,058	+ 10.6	185,117	203,377	12.7	12.8
39	Total beverages	73,992	65.582	— 11.4	343,178	375,152	21.6	17.5
11	Tobacco products	56,322	51,008	— 9.4	449,659	458,074	12.5	11.1
36	Cotton goods	28,790	26,014	— 9.6	232,864	248,793	12.4	10.5
6	Silk and rayon	4,007	4,012	+ 0.1	37,654	37,702	10.6	10.6
5	Woolen goods	9,393	8,000	— 14.8	82,054	86,785	11.4	9.2
11	Knitted goods	3,766	3,761	— 0.1	39,682	40,933	9.5	9.2
20	Misc. textile products	18,970	16,358	— 13.8	140.497	151,037	13.5	10.8
78	Total textile products	64,926	58.145	— 10.4	532,751	565,250	12.2	10.3
17	Clothing and apparel	10,402	10,358	— 0.4	88,191	91,522	11.8	11.3
5	Leather tanning	4,104	4,237	+ 3.2	34,625	35,918	11.9	11.8
14	Shoes, etc.	14,867	14,839	— 0.2	161,529	165,468	9.2	9.0
19	Total leather products	18,971	19.076	+ 0.6	196,154	201,386	9.7	9.5
17	Rubber products	45,329	41,747	— 7.9	396,620	415,437	11.4	10.0
12	Lumber	8,240	6,817	— 17.3	46,619	54,215	17.7	12.6
6	Other wood products	1,516	1,304	— 14.0	11,923	12,724	12.7	10.2
18	Total wood products	9,756	8,121	— 16.8	58,542	66,939	16.7	12.1
34	Paper products	38,338	31,981	— 16.6	361,365	381,642	10.6	8.4
9	Printing and publishing	1,920	1,762	— 8.2	31,303	32,272	6.1	5.5
19	Chemicals—industrial, etc.	133,200	105,652	— 20.7	964,688	1,025,506	13.8	10.3
10	Drugs, soap, etc.	47,174	38,905	— 17.5	220,579	233,362	21.4	16.7
7	Fertilizer	3,473	7,051	+	81,050	83,181	4.3	8.5
9	Paint and varnish	12,277	9,812	— 20.1	105,510	112,931	11.6	8.7
45	Total chemical products	196,124	161,420	— 17.7	1,371,827	1,454,980	14.3	11.1
15	Petroleum products	126,222	100,763	— 20.2	1,419,726	1,444,702	8.9	7.0
6	Cement, gypsum, etc.	12,659	10,397	— 17.9	120,232	123,091	10.5	8.4
16	Other stone, clay and glass	24,398	22,785	— 6.6	221,868	219,541	11.0	10.4
22	Total stone, clay and glass	37,057	33,182	— 10.5	342,100	342,632	10.8	9.7
33	Iron and steel	291,196	197.704	— 32.1	3,081,390	3,220,484	9.5	6.1
10	Agricultural implements	22,454	20,716	— 7.7	202,165	214,257	11.1	9.7
16	Building equipment	7,450	7,162	— 3.9	41,401	45,811	18.0	15.6
21	Electrical equipment	26,806	19,101	— 28.7	210,749	218,443	12.7	8.7
17	Hardware and tools	9,885	9,952	+ 0.7	50,174	54,031	19.7	18.4
11	Household equipment	6,886	4,481	— 34.9	29,153	31,505	23.6	14.2
60	Machinery	45,004	42,775	— 5.0	212,971	235,314	21.1	18.2
8	Office equipment	13,944	12,475	— 10.5	61,163	67,810	22.8	18.4
9	Nonferrous metals	34,239	27,841	— 20.1	279,700	302,885	12.5	9.2
33	Misc. metal products	41,215	33 134	— 19.6	330,604	347,932	12.5	9.5
218	Total metal products	499,679	375.341	— 24.9	4,499,470	4,738,472	11.1	7.9
37	Autos and equipment	31,591	29,440	— 6.8	170,121	189,913	18.6	15.5
13	Railway equipment	32,918	39,274	+ 19.3	336,071	354,799	9.8	11.1
23	Other trans. equipment	39,215	55,449	+ 41.4	81,650	103,710	48.0	53.5
73	Total trans. equipment	103,724	124,163	+ 19.7	587,842	648,422	17.6	19.1
11	Misc. manufacturing	3,886	2,493	— 35.8	43,308	44,487	9.0	5.6
710	Total manufacturing	$1,397,142	$1,209,921	— 13.4	$12,022,121	$12,584,792	11.6	9.6

† Increases of more than 100 per cent not computed.

approximately $1,315 millions in 1941 to $2,395 millions in 1942, based on tax details given by companies accounting for nine-tenths of the total net income in 1942. The effect of such taxes, which absorbed about 66 per cent of net income in 1942 against 48 per cent in 1941, is shown in the table opposite. This table, and the summary above includes companies having fiscal years ending prior to December 31 and therefore subject to the higher tax rates only since July 1, thus tending somewhat to overstate the aggregate earnings on a calendar year basis and understate the part taken by taxes.

710 Leading Manufacturing Companies
(In Millions of Dollars)

	1941	1942	% Chg.
Net income before taxes	$2,712	$3,605	+32.9
Fed. income & e.p. taxes*	1,315	2,395	+81.2
Net income after taxes	$1,397	$1,210	—13.4
Percentage of net income taken by taxes	48.5%	66.4%	

*After deducting post-war credits.

Application of the high tax rates in 1942 not only caused a decline as compared with 1941 in the net income after taxes, but also a much sharper decline in margin of profit per dollar of sales. The decline in net income was responsible for reduction or omission of many dividends last year, although another important factor was the need for conserving cash in view of swollen inventories, receivables, tax reserves and other indebtedness.

The preceding summary shows, for major industrial groups, the comparative net income after taxes in 1941 and 1942, together with net worth and rate of return. The number of companies for which reports are available at this date is somewhat smaller than usual, owing to delays in the issuance of statements.

In examining the summary, it must be borne in mind, as pointed out heretofore, that the promptly published reports of a limited number of publicly owned, large companies are useful as indicating earnings trends, but do not provide an accurate measure of average earnings in an entire industry, including the large numbers of small organizations.

Moreover, this year many of the reports call attention to the fact that earnings as given are subject to the renegotiation of government contracts for producing goods of many different varieties, and that any adjustment of selling prices will affect income and tax reserves correspondingly. Savings by renegotiation were placed by the Navy Department at the end of last September in the neighborhood of $2 billions, and by the War Department at $600 millions. To state the figures this way, however, is misleading. It should be pointed out that these "savings" are before taxes, so that the actual savings to the Government are perhaps not more than a fourth of that amount. Such review and renegotiation is going on continually, and has the effect of reducing previously reported earnings, unless the contractor has already made provision for the reduction in this way of earnings increased through quantity output, improved efficiency and economies in production.

In some cases renegotiation has been fully reflected by deduction from the 1942 sales figures in the published statements; in others, allowed for by setting up a reserve out of earnings; and in still others no specific provision has been made.

Among the major lines shown in the summary, the changes in earnings from 1941 to 1942 seem more uneven than is usually the case, since they reflect the widely differing effects of the war and the high tax impact. It will be observed that some of the food, beverage, tobacco, apparel and other "peace" industries had relatively better earnings than the steel and various industries now devoted or converted almost wholly to war production and having much larger gains in sales.

The value of such comparisons, however, is restricted because of the fact that so many companies classified in their customary peacetime industrial groups have taken large war contracts and branched out into entirely new fields. Automobile companies are making tanks, guns and airplanes, tire companies are making airplane parts, building materials and food companies are making shells and ammunition, and so on. Moreover, since last Fall the earnings position of the meat packing, baking and other food processing companies has been changed drastically by the squeeze of rising costs against fixed selling prices.

Earnings Trend in Recent Years

For the trend of earnings over a period of years, a condensed summary is given below of Treasury Department "Statistics of Income" for all manufacturing corporations in the United States through 1940, the latest year for which official figures are available, and of our own tabulations of leading manufacturing companies through 1942 as given in the March issues.

Net Income of Manufacturing Corporations
(In Millions of Dollars)

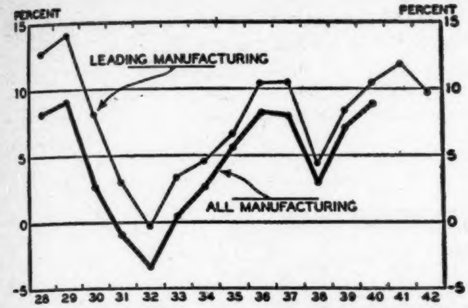
	All Mfg. Corp. in U. S.			Leading Mfg. Corp.			
Year	Net Income aft. Tax	Net Worth Jan. 1	Per Cent Return	Number	Net Income aft. Tax	Net Worth Jan. 1	Per Cent Return
1928	$3,935	$48,050	8.2	827	$2,087	$16,261	12.8
1929	4,537	50.017	9.1	827	2,444	17,266	14.2
1930	1,424	52,695	2.7	717	1,499	18,223	8.2
1931	D-521	52,122	D-1.0	712	456	14,642	3.1
1932	D-1,616	47,640	D-3.4	670	D-36	13,565	D-0.3
1933	237	43,976	0.5	653	359	12,152	3.0
1934	1,166	43,342	2.7	676	582	11,564	4.6
1935	2,122	38,152	5.6	734	822	12,251	6.7
1936	3,116	37,611	8.3	789	1,413	13,623	10.4
1937	3,069	38,467	8.0	940	1,545	14,705	10.5
1938	1,228	41,239	3.0	940	672	15,202	4.4
1939	2,946	41,260	7.1	960	1,281	15,181	8.4
1940	3,775	42,438	8.9	925	1,554	14,803	10.5
1941	—	—	—	825	1,539	12,931	11.9
1942	—	—	—	710	1,210	12,585	9.6

D- Deficit.

Treasury statistics show that in 1940, the 85,588 active manufacturing corporations filing returns had sales and other income (including dividends received from other corporations, and wholly tax-exempt interest from government securities) of $66,991 millions. The combined net income (less deficits) was $3,775 millions, after taxes of $3,372 millions of which federal income and excess profits taxes were $1,541 millions and state, local and miscellaneous federal taxes $1,831 millions.

This contrasts with 1929, when net income was at a peak of $4,537 millions, after total taxes of $1,161 millions.

The following chart compares return for all manufacturing companies through 1940, as reported by the Treasury, and for leading companies through 1942, as shown by our tabula-



Annual Rate of Return on Net Worth of All Mfg. Corp. and of Leading Mfg. Corp.

Composite Income Account and Balance Sheet of 100 Manufacturing Companies with Sales or Total Assets over $5 Millions

(In Millions of Dollars)

Income Account	Year 1940	Year 1941	Year 1942	Change 1940-42
Sales	$3,580	$4,797	$5,611	+2,031
Net income before taxes	491	773	799	+ 308
Income & exc. prof. taxes	151	397	497	+ 346
Net income after taxes	340	376	302	— 33
Dividends paid	258	274	206	— 52
Retained net income	82	102	96	+ 14
Assets, Dec. 31				
Cash	456	383	488	+ 32
U. S. Govt. securities*	37	244	376	+ 339
Receivables, net	376	486	580	+ 204
Inventories	1,016	1,235	1,347	+ 331
Total current assets	1,885	2,348	2,791	+ 906
Plant and equipment	2,717	2,824	2,838	+ 121
Less depreciation	1,198	1,264	1,330	+ 132
Net property	1,519	1,560	1,508	— 11
Other assets	506	529	554	+ 48
Total assets	3,910	4,437	4,853	+ 943
Liabilities & Capital, Dec. 31				
Notes payable	44	91	110	+ 66
Accts. pay. & accruals	229	303	436	+ 207
Reserve for taxes	196	461	567	+ 371
Total current liab.	469	855	1,113	+ 644
Deferred liabilities	347	353	406	+ 59
Reserves	104	132	151	+ 47
Capital and surplus	2,990	3,097	3,183	+ 193
Total	3,910	4,437	4,853	+ 943
Working capital	1,416	1,463	1,678	+ 262
Current ratio	4.02	2.65	2.51	

* Includes U. S. tax notes of $201 millions in 1941 and $291 millions in 1942.

tions. While the figures for leading companies run consistently higher than for all companies, they have proved to be closely indicative of the trend. The decline in 1942 in the sampling of leading companies carried earnings slightly below the 1936-37 level, and considerably below the 1928-29 level, despite the tremendous growth in volume of production in the meantime.

The disparity between actual dollar earnings in 1929 and 1942 is even wider than shown by the percentage return on net worth, since the later reflects the heavy losses and writing down of assets and capital valuations during the 1930s shown in the table, thus lowering the base on which rate of return is computed.

Changes in Working Capital Position

Analysis of the balance sheets now available for 100 of the larger manufacturing companies, having sales or total assets over $5 millions and with fiscal years ended December 31, shows that the further expansion in volume of sales in 1942, following that of 1941 when the national defense program and the conversion of industry were just getting under way, was accompanied by a substantial increase in inventories and receivables, with a corresponding increase in tax reserves and other liabilities, and a consequent decrease in liquidity. On this page is the composite income account and balance sheet for the years 1940 to 1942.

Between 1940 and 1942, sales of these companies increased 57 per cent, and taxes 229 per cent, while net income after taxes decreased 11 per cent and dividends paid 20 per cent.

The increase in inventories, stated at dollar values, was at a somewhat lower rate than sales, while that of receivables was about the same. Cash on hand increased, and government securities, principally tax notes, increased to $376 millions, against tax liability of $567 millions. Of the current liabilities, the largest increase was in reserve for taxes, although notes payable, accounts payable and accruals also were higher.

Total current assets increased more than did total current liabilities, so that the net current assets, or working capital, showed an increase. Because of the expansion on both sides of the statement, however, the ratio of current assets to current debt declined from 4.02 at the end of 1940 to 2.51 at the end of 1942.

While the familiar "current ratio" has long been regarded as a valuable guide as to liquidity, its significance in times like today is subject to unusual qualifications as to the assets. Under present conditions many concerns have inventories consisting principally of war products and materials having little or no peacetime value, and have receivables due from other concerns likewise situated, in addition to their receivables due from the Government.

The ability of many companies, now greatly expanded on war work, to employ labor after the war and to finance the conversion of their plants back to the production of peacetime goods will depend in large measure on their maintaining a sound working capital position. Fortunately the 1942 statements show that a growing number of companies have created or increased reserves variously designated as "general", "special", "contingency", "postwar", etc., but the aggregate of such reserves is still comparatively small relative to total assets or capital funds.

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